FX Daily: Relentless energy rises re-price terminal rates and FX

For the inflation hawks, perhaps one of the most worrying pieces of news recently is that OPEC+ is struggling to deliver on its planned supply increases. Firm energy prices are contributing to the re-pricing of tightening cycles, where expectations of the Fed's terminal rate have risen 20bp over the last week alone. This should keep the dollar supported.

USD: Fed's terminal rate now expected at 1.80%

What seemed like a compelling theme last week to explain FX market price action lost some support yesterday. Last week's dollar weakness was being ascribed to higher US yields denting US growth/tech stocks and triggering a rotation into the more heavily value-weighted equity markets in Europe. Yesterday, US yields rose and US tech stocks dropped but the dollar rallied broadly.

We would take a more vanilla approach to FX where the proximity of Fed lift-off is triggering bearish flattening of the US yield curve - as the Fed is expected to apply the monetary brakes - which is typically a bullish story for the dollar against low-yielding currencies like the EUR and JPY. Activity currencies, especially energy exporters, should be able to better withstand dollar appreciation pressure and it is pleasing to see one of our preferred trends - a lower EUR/CAD - breaking to a new low yesterday.

On the subject of energy - and in addition to supply disruptions - we were taken by a comment made by our commodities team today that OPEC supply increases in December failed to live up to what was agreed by OPEC+. It seems higher energy prices may linger and may delay any sharp turn lower in headline CPI later in the year.

This environment is seeing the scale of expected tightening cycles increase around the world, including in the US. The terminal rate for the Fed Funds cycle is now priced at 1.80% versus 1.60% last week. It has not been a surprise to see the market starting to speculate about 50bp Fed increments.

As we discuss in this month's FX talking we prefer those currencies backed by hawkish central banks - i.e. those central banks that would prefer strong currencies to ride out the 1H22 inflation hump. Into this category, we would put: USD, GBP, CZK and PLN.

For today, expect the focus to remain on US bond yields and equity markets. Goldman Sachs unnerved equity markets with a softer trading performance in 4Q than expected. Let's see if equities can settle a little today, although we do see another round of US bank earnings. Overall we favour DXY continuing its recovery towards the 96.40/50 area.

EUR: Dovish ECB leaves EUR vulnerable

Eurozone interest rates are being dragged higher in this environment - but nowhere near as aggressively as those in the US. Driving that wedge is probably a consideration such as an output gap, where the US is expected to grow 3% above capacity this year (meaning second-round inflation risks are higher), while the Eurozone still runs a negative output gap.

It may also be too early to say that tension in Eastern Ukraine is starting to weigh on European currencies as a whole - though any escalation here would clearly favour the dollar too. In terms of politics, our team is also a little concerned about Italian politics later this month.

EUR/USD yesterday broke back into a bearish trend channel from last June's high and a modest extension to the 1.1275 area is favoured on a quiet day for the data calendars.

GBP: Another upside surprise for UK inflation

UK December CPI has just come in at 4.8% YoY and core 4.2% YoY - both surprising on the upside. This is all consistent with headline heading up to the 6% YoY area in April - as the BoE predicts. Combined with better November activity data and better jobs data, ING's James Smith favours a 25bp BoE BoE hike on Feb 3rd. An awful lot is priced for the BoE cycle - yet we think it is too early to 'fade' the GBP rally on a fully-priced BoE cycle - just in the same way it is too early to fade the dollar rally.

For today, look out for testimony from BoE Governor Bailey on financial stability at 1515CET. Presumably, we should hear hawkish comments as to how the BoE will address inflation. Expect EUR/GBP to continue working its way towards the 0.8270/80 area - despite intense speculation over PM Johnson's future.

CAD: Outperformance set to continue

Canada releases December CPI data at 1430CET today, with the market probably bracing for an upside surprise. The CAD continues to perform well on the crosses and one of the core trends from our 2022 FX Outlook was that EUR/CAD would trade down to 1.38. EUR/CAD broke down to a new cyclical low yesterday and we look for a continuation of this move.

The biggest risk here probably comes from any disorderly equity sell-off, which would likely see the high-beta CAD underperform. But arguably a Fed taking care of inflation - at a time of strong domestic demand - should not be overly bad news for equities as an asset class - an asset class that is normally the last to turn in the economic cycle.

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